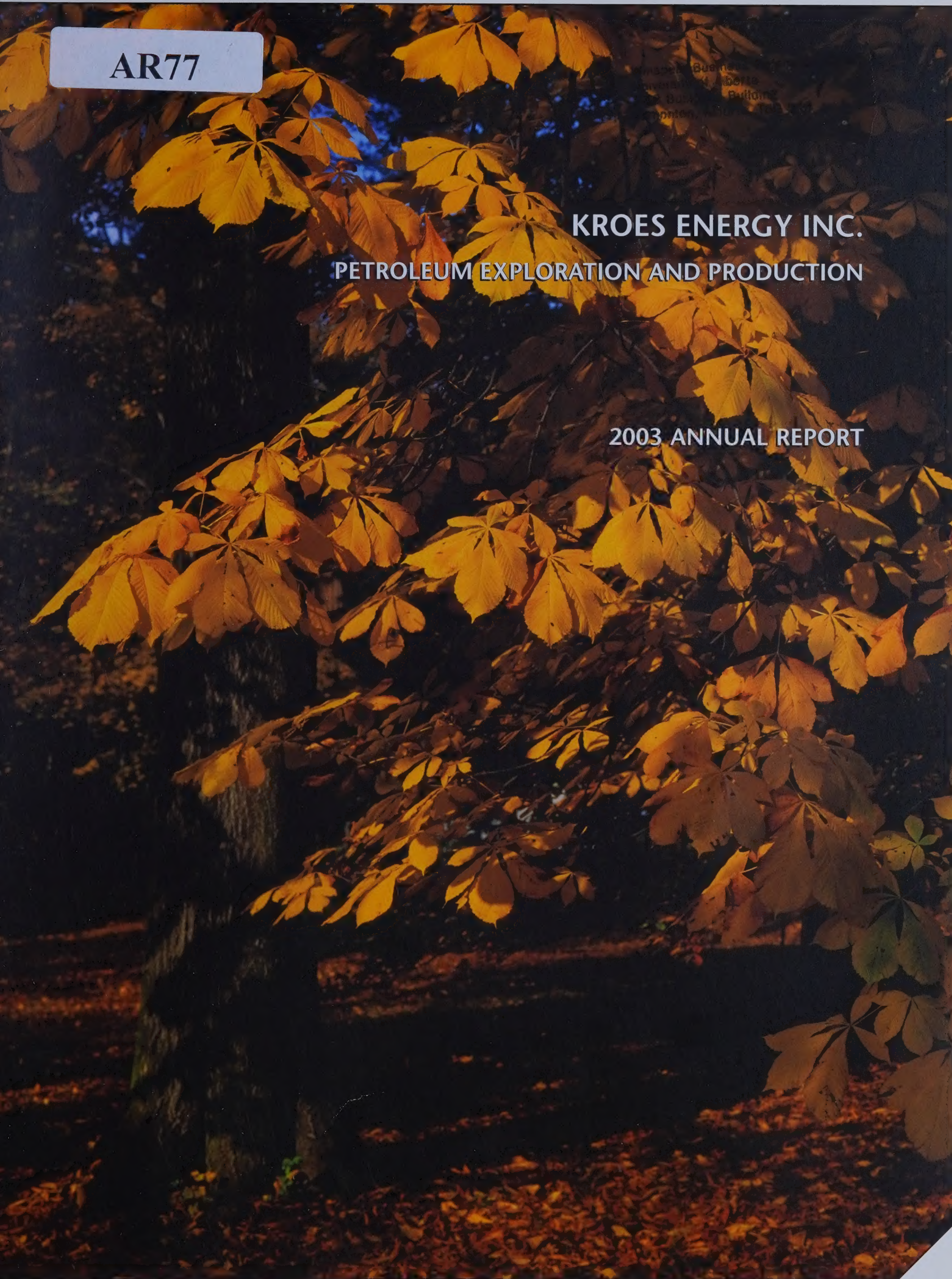


KROES ENERGY INC.

PETROLEUM EXPLORATION AND PRODUCTION

2003 ANNUAL REPORT

THE CHESTNUT TREE

The cover of this year's annual report depicts the Chestnut Tree. We decided to feature this tree on our Annual Report cover as it represents several major strengths. The tree itself is found extensively in Eastern Europe and is prominently featured in the City of Kyiv, Ukraine. The City of Kyiv is known throughout Europe as the Green City and its Chestnut trees during their peak period of bloom in June present an extremely beautiful and wonderful panorama throughout. There are two kinds of Chestnut trees in Kyiv, the White, which is common and the Red, which is placed in very selected areas of special national importance. The trees grow to a height of 90 feet and higher and produce Chestnuts in the fall. They are both a source of beauty, strength and nourishment. The word for Chestnut in Ukrainian is Kashtan. This is the name of our Ukrainian Joint Venture - Kashtan Petroleum Ltd.

CORPORATE PROFILE

Kroes Energy is a junior oil and gas producer and explorer with a major oil field redevelopment project in Ukraine, Eastern Europe's fastest growing economy, and production in Trinidad. Kroes has a strong management team, with extensive international experience. Shares trade on the TSX Venture Exchange under the symbol KRS.

ANNUAL GENERAL MEETING

The Annual General Meeting of the Shareholders will be held in Calgary on June 21 at 3:00 p.m. in the Cardium Room of the Calgary Petroleum Club, 319 – 5 Avenue S.W.

All dollar amounts in this Annual Report are in Canadian currency unless otherwise noted.

2003 HIGHLIGHTS

Net earnings increase to $1.2 million from a loss of $326,000 in 2002.

Cash from operations increases to $1.3 million from $80,000 in 2002.

Production increases six fold to 293 boe per day.

First dividend received from Kashtan Petroleum Ltd. joint venture in Ukraine.

Kashtan completes license obligations and will take over the Lelyaki oil field.

Net Asset Value estimated at $ 2.16 per share based on new reserve evaluations.

LETTER TO SHAREHOLDERS

As predicted a year ago, the acquisition of Zhoda 2001 Corporation and its 45% interest in the Kashtan Petroleum Ltd. Ukrainian joint venture had a major positive impact on the Company in 2003. The acquisition was effective on December 31, 2002 so Kroes' share of operating and financial results were first recorded in 2003.

Results for 2003

Kroes Energy Inc. recorded a net profit of $1,208,920 for 2003 compared with a net loss of $325,855 in 2002. Cash from operations amounted to $1,266,379 compared with $79,932 in 2002. On a weighted per share basis, net earnings were $0.04 and cash from operations was $0.05.

This large improvement in financial results arose from production volumes that averaged 293 barrels of oil equivalent per day in 2003, a six fold increase from the 50 barrels per day recorded by Kroes in 2002. The entire increase is attributable to Kroes' share of Ukrainian production.

Other highlights of the year include:

The receipt of the first dividend of $166,000 from the Kashtan Petroleum Ltd. joint venture in April of 2003, that confirmed the ability to transfer Kroes' return on investment back to Canada;

The confirmation by Ukrainian regulatory authorities that the joint venture has satisfied all of its license obligations and has earned the right to take over operations of the Lelyaki oil field;

Sale of the Company's Saskatchewan properties for $475,000 effective December 1, 2003. The Saskatchewan properties provided Kroes with cash flow to operate the Calgary office for seven years but the very high and rising operating costs and the onerous new reserve reporting requirements that apply to small public companies prompted the Company to sell them.

Early in 2004

In April of 2004, Kroes received its second annual dividend from the Kashtan joint venture in the amount of $350,000, double the amount received in 2003.

PetroGlobe Canada Ltd. completed an update to the engineering report on the Lelyaki oil field that indicates proved, probable and possible reserves of 15.6 million barrels having a net present value of $64.2 million at a 10% discount rate. With the inclusion of working capital, funds on deposit in Ukraine and proceeds from warrants received in 2004, management estimates the current net asset value of the Company at $2.16 per share.

Well 187b began drilling on April 1, 2004. At the date of this report, it had reached total depth and testing was underway.

Warrants to purchase common shares that were issued in the 2002 financing became due on February 29, 2004 and 4,260,200 were exercised at 30 cents bringing $1,278,060 to Company coffers.

Two new officers were added to the Company roster with the appointment of Stewart Gossen as Vice President, Business Development and Dave Malarchuk as Controller.

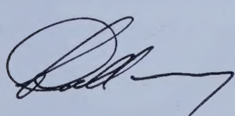
Outlook for 2004

With the Company relying on the Ukrainian project to provide growth, an aggressive four well drilling program is in place for 2004 as well as a number of workovers of shut in wells. In addition, the Kashtan joint venture will complete the takeover of the operation of the Lelyaki oil field bringing more efficiency to the operation.

Kroes also intends to investigate some of the many oil and gas development and exploration opportunities in Ukraine. We have now developed excellent contacts in business and government, have an infrastructure in place and have initiated discussions with a number of potential partners. Following the sale of the Saskatchewan properties Kroes will continue to seek attractive oil and gas opportunities in Canada.

We look forward to continued rapid growth in 2004 with the drilling program already underway. While the impact of new projects is unlikely to occur in 2004 we expect the drilling and workover program at Lelyaki to add significant new production during the year.

On behalf of the Directors,



Fred Callaway, President

May 13, 2004

OPERATIONS REVIEW

UKRAINE

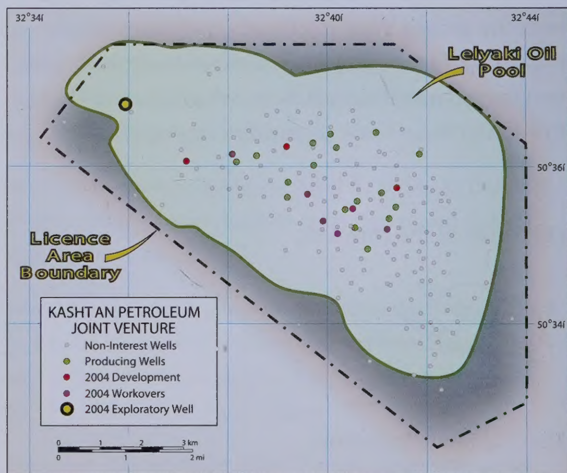
All of the Company's resources were concentrated on the Ukrainian joint venture and several important milestones were reached, but the work program originally planned for 2003 was not accomplished due to a management restructuring undertaken by our partner, Ukranafta JSC.

During 2003, the Kashtan joint venture commissioned a full engineering and field development study that represented the last of its license obligations. The study was prepared by a Ukrainian Consulting Engineer and was completed and submitted to a Committee of appropriate regulatory authorities. The Committee agreed that the license obligations had been completely satisfied and that as of October 1, 2003 Kashtan Petroleum Ltd. had the right to take over operations of the Lelyaki oil field from the partner, Ukranafta JSC.

This process of field takeover is a first in Ukraine so progress has been slow. It is necessary for Ukrnafta to determine the value of the field facilities required by Kashtan; determine whether these facilities should be sold, leased or rented; then negotiate and finalize the necessary agreements. It is expected that all arrangements will be in place in order to transfer operations this year. The takeover of operations by Kashtan will be extremely advantageous to the joint venture. It will simplify operating procedures, allow for more efficient field operation, and should result in lower unit operating costs.

In April of 2003 the Directors of Ukrnafta JSC replaced essentially all of its senior management. The new management immediately undertook a comprehensive review of all of the Joint Investment Projects and the Joint Ventures in which Ukrnafta participated to determine if all of the license obligations had been met, with the objective of eliminating those projects that were unsuccessful or unfunded. A ban was placed on all new activity until the review was complete. Despite the fact that the Kashtan Petroleum Ltd. joint venture was very successful and in good standing, Ukrnafta applied the ban to Kashtan's activity and

would not approve new drilling or workovers. As a consequence, it was not until September of 2003 that Ukrnafta completed its review and Kashtan was able to get its drilling program underway. In addition, only one workover of the planned program of eight was completed in 2003 for these same reasons.



Exploratory well 187 began drilling early in September with the objective to extend the existing field to the northwest. Unfortunately, the main P1 and P2 producing formations were encountered 10 meters low to prognosis and were water saturated. The well was plugged back to 300 meters and suspended while plans were being drawn to use the well bore to drill directionally to the north east to a bottom hole location some 60 meters from a deep gas well drilled a number of years ago, where log data indicated 5 meters of pay in the main P1-P2 producing sand. Well 187b began drilling on April 1, 2004.

Production during 2003 remained relatively constant with the average for the year at 253 barrels per day and the exit rate in December at 257 barrels per day. The year average, however, was still some 50% higher than the 169 barrels per day averaged in 2002 due to the full year impact of the active program in 2002.

The 2003 netback for Kroes interest in the Kashtan joint venture is:

	Canadian $/Bbl
Oil Price	$36.64
VAT	$7.33
Operating Cost	$6.32
Operating Margin	**$22.99**
Administration	$1.37
Income Taxes	$4.84
Netback	**$16.78**

SASKATCHEWAN

The Company sold its Saskatchewan production for $475,000 effective December 1, 2003. The Company's Saskatchewan crude oil reserves were situated in two fully developed low productivity oil fields and although crude oil production was high quality and attracted a premium price, the low productivity wells made the production costs very high.

In 2003, the Saskatchewan production generated $201,473 of operating cash flow, compared with $224,120 in 2002. Crude oil production in 2003 averaged 30 barrels per day and associated natural gas provided 6 barrels of oil equivalent per day. Operating costs in 2003 increased to $25.90 per barrel, up from $24.68 in 2002. Production and cash flow were lower in 2003 due to normal production declines and due to the sale of the properties being effective December 1, 2003.

The details of comparative production, prices and netbacks are provided on pages 10 and 11.

TRINIDAD

On the Icacos Block of the Cedros Peninsula, Trinidad, where Kroes' has a 25% working interest, its share of production amounted to four barrels per day. Operating cash flow before administrative costs was $19,440, down slightly from 2002. Crude oil reserves in Trinidad are situated in a small fully developed oil field. An independent engineering report has not been prepared due to the small working interest and low production volumes. The Company and its partners are continuing to seek approval to evaluate a shallow light oil discovery on the block by means of stratigraphic test holes. If approval is received, these test holes will determine the extent of the deposit and if the results are encouraging a development plan will be implemented. In addition, the acreage contains deep exploration potential that would require 3-D seismic coverage. The Company intends to hold this interest until industry activity prompts an interest for a potential exploratory farming. Comparative production, prices and netbacks are provided on pages 10 and 11.

RESERVES

This is the first year Kroes has reported its oil and gas reserves in its Annual Report to shareholders. The reserves report for Kroes' Ukrainian project was prepared by the independent petroleum consulting firm PetroGlobe (Canada) Ltd. The Company's reserve disclosure is based on National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities. Under NI 51-101 there is a 90 percent probability that actual reserves will equal or exceed reported proved reserves. Probable reserves are risked by 50% and possible reserves are risked at 90% before they are disclosed. The values in the PetroGlobe report were prepared in United States dollars and for the following presentation, have been converted to Canadian dollars at the December 31, 2003 rate of 1.2965.

KROES ENERGY INC. ESTIMATED RESERVES FOR LELYAKI FIELD AS AT DECEMBER 31, 2003

	Barrels
Proved	
Producing	1,442,000
Undeveloped	7,857,000
Total Proved	9,299,000
Proved Plus Probable	14,602,000
Proved, probable and possible	15,583,000
Total Resource Potential (1)	24,414,000

(1) Total resource potential = Total estimated reserves before risk parameters are applied.


Interior of a "sputnik" gathering and measuring facility in a Lelyaki field.

NET PRESENT VALUES OF FUTURE NET REVENUES CONSTANT PRICES AND COSTS - CRUDE OIL

	Before Tax $CDN		After Tax $CDN	
	0%	10%	0%	10%
Proved				
Producing	$22,625,000	$13,150,000	$17,325,000	$10,065,000
Undeveloped	$127,118,000	$45,170,000	$97,547,000	$34,633,000
Total Proved	**$149,743,000**	**$58,320,000**	**$114,872,000**	**$44,698,000**
Proved Plus Probable	**$240,302,000**	**$92,175,000**	**$184,132,000**	**$70,587,000**
Proved Plus Probable Plus Possible	**$257,807,000**	**$99,575,000**	**$197,556,000**	**$76,254,000**
Total Resource Potential	**$422,981,000**	**$171,654,000**	**$323,806,000**	**$131,348,000**

The Company has estimated the net present value of future net revenues from its share of reserves and production from the Lelyaki oil field using constant prices and costs based on December 2003 actual results. The price used in this calculation is US$28.02 per barrel and operating costs are US$6.50 per barrel. Values have been converted to Canadian dollars using a $1.2965 exchange rate. Net present values have been calculated without discounting and using a discount factor of 10%.

NET PRESENT VALUES OF FUTURE NET REVENUES

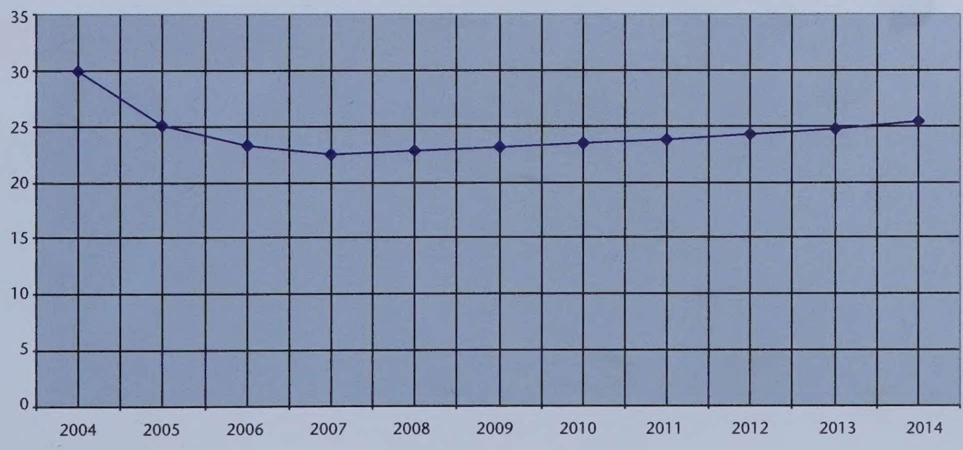
FORECAST PRICES AND COSTS

CRUDE OIL

	Before Tax $CDN		After Tax $CDN	
	0%	10%	0%	10%
Proved				
Producing	$19,694,000	$11,090,000	$15,169,000	$8,534,000
Undeveloped	$121,723,000	$37,335,000	$93,934,000	$28,866,000
Total Proved	**$141,417,000**	**$48,425,000**	**$109,103,000**	**$37,400,000**
Proved Plus Probable	**$228,981,000**	**$77,245,000**	**$176,401,000**	**$59,585,000**
Proved Plus Probable Plus Possible	**$244,817,000**	**$83,199,000**	**$188,623,000**	**$64,183,000**
Total Resource Potential	**$395,492,000**	**$142,607,000**	**$304,428,000**	**$109,902,000**

The Company has also estimated future net revenues from the Lelyaki oil field using forecast prices and costs. The oil price forecast, graphed below, prepared by PetroGlobe (Canada) Ltd. projects prices rising to US$29.90 per barrel in 2004, then declining to US$22.50 per barrel in 2007 when oil prices are predicted to begin rising. Costs are assumed to increase at 1.5% per year beginning in 2004. Future net revenues have been calculated without discounting and using a 10% discount factor. A $1.2965 exchange rate has been assumed when converting to Canadian dollars.

FORECAST CRUDE OIL PRICES
US$ PER BARREL



NET ASSET VALUE

Management has calculated a net asset value per share in early 2004 based on the values determined from the Lelyaki reserve report. Using after tax 10% and 15% discount rates for reserves, year end working capital and funds on deposit as well as first quarter proceeds from the share purchase warrants the net asset value of the Company is estimated as follows:

	10% NPV	15% NPV
Working Capital and Cash	$4,200,000	$4,200,000
Reserves – proven, probable (risked at 50%) and possible (risked at 90)	$64,183,000	$44,006,000
Net Asset Value	$68,383,000	$48,206,000
Net Asset Value per share – Basic	$2.16	$1.52

In management's opinion, discount rates of 10% and 15% conservatively reflect the range of returns that investors would expect from Kroes' Ukraine reserves.


Lelyaki #184 Wellhead

Drilling of Lelyaki #187

PetroGlobe
(Canada) Ltd.

May 07, 2004

Form 51 - 101 F2
Report on Reserves Data by Independent Qualified Reserves Evaluator

To the Board of Directors of Kroes Energy Inc. (Kroes)

1 PetroGlobe (Canada) Ltd. (PetroGlobe) has evaluated Kroes' reserves data as at December 31, 2003. The reserves data consist of the following:

a) Forecast Cases

i Proved and proved plus probable oil reserves estimated as at December 31, 2003 using forecast prices and costs; and
ii the related estimated future net revenue; and

b) Constant Cases

i. proved oil reserves estimated as at December 31, 2003 using constant prices and costs; and
ii. the related estimated future net revenue

2 The reserves data are the responsibility of Kroes management. PetroGlobe's responsibility is to express an opinion on the reserves data based on our evaluation

PetroGlobe carried out our evaluation in accordance with standards set out in the Canadian Oil and Gas Evaluation Handbook (the "COGE Handbook") prepared jointly by the Society of Petroleum Evaluation Engineers (Calgary Chapter) and the Canadian Institute of Mining, Metallurgy & Petroleum (Petroleum Society)

3 The above standards require that we plan and perform an evaluation to obtain reasonable assurance as to whether the reserves data are free of material misstatement. This evaluation also includes assessing reserves data in accordance with principles and definitions presented in the COGE Handbook.

4 The following table sets forth the estimated future net revenue (before deduction of income taxes) attributed to proved plus probable reserves, estimated using forecast prices and costs and calculated using a discount rate of 10 %. These values, as evaluated by PetroGlobe for the year ended December 31, 2003, are included in the reserves data of Kroes and have been reported to Kroes management and Board of Directors.

Suite 440, 736 – 8th Avenue S.W. Calgary, Alberta, Canada T2P 1H4 Tel 403-265-4488 Fax 403-265-9727

Forecast Case Indicators:

Independent Qualified Reserves Evaluator: PetroGlobe (Canada) Ltd.
Dzintra Ziemelis, P. Eng.

Report: Evaluation of Lelyaki Field, Ukraine
Prepared for Zhoda 2001 (a wholly owned subsidiary of Kroes Energy Inc.)
Effective Date December 31, 2003
Report Date: April 15, 2004

Location of Reserves: Lelyaki Field, Ukraine

Evaluated NPV of Future net revenue
(before income tax @ 10 % discount rate): 59,580 K$ USD

5. In our opinion, the reserves data respectively evaluated by PetroGlobe (us) have, in all material respects, been determined and are in accordance with the COGE Handbook. We can only express an opinion on the reserves data that we evaluated, specifically, Lelyaki Field, Ukraine.

6. We have no responsibility to update our reports referred to in paragraph 4 for events and circumstances occurring after their respective preparation dates.

7. Because the reserves data are based on judgements regarding future events, actual results will vary and the variations may be material.

Executed as to our report referred to above:

PetroGlobe (Canada) Ltd.
Calgary, Alberta, Canada

Execution Date: May 07, 2004

Dz Ziemelis
Dzintra Ziemelis, P. Eng.

PETROGLOBE PGCL 20597595 (CANADA) LTD

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

A full year of production in 2003 from the Ukrainian assets acquired on December 31, 2002 resulted in production of 293 barrels of oil equivalent per day (boe/d) a six fold increase from 50 boe/d in 2002. This production resulted in cash flow from operations increasing to $1,266,379 for 2003 from $79,932 in 2002. On a weighted outstanding share basis, cash flow from operations increased to $0.05 from nil in 2002. After non-cash charges, the Company showed a profit of $1,208,920 compared to a loss of $325,855 in 2002. The Company's Saskatchewan production was sold on December 1, 2003.

Revenue & Production

With the addition of the Ukraine production, gross revenue increased to $3,000,736 in 2003 from $632,669 in 2002. Oil production volumes increased to 287 barrels per day from 42 barrels per day in 2002 while gas production fell to 6 boe/d in 2003 mainly as a result of the Saskatchewan property sale in December 2003. Kroes average price in 2003 was $37.32, slightly lower than the $38.02 received in 2002. The table below sets out the relevant variables for Kroes oil and gas production.

Royalties

Royalty payments were $31,399 in 2003 compared to $33,115 in 2002. The sale of the Saskatchewan properties in December 2003 resulted in lower royalty payments in 2003. Royalties include gross overriding and freehold royalties, and averaged 5.0% for oil and 8.6% for gas revenue in 2003 compared to 5.3% and 7.8% respectively in 2002. Royalties are only paid in Canada as there are no royalties on the Trinidad and Ukraine production.

Operating Expenses

The 2003 production costs of $888,007 were significantly higher than the 2002 production costs of $408,549 due to the inclusion of Ukraine operations in 2003. Operating costs per barrel averaged $8.29 per barrel in 2003 versus $24.11 per barrel in 2002. Operating costs in Ukraine were $6.32 per barrel whereas Saskatchewan production averaged $25.90 per barrel.

On a barrel of oil equivalent basis, Saskatchewan production costs were $25.90 per barrel in 2003 compared with $24.68 in 2002. Lower production rates were the primary reason for the increase in unit costs as the largest component of the operating costs are fixed property taxes, lease rentals and operating and administrative expenses. The Trinidad production costs totaled $26,878 or $18.73 per barrel in 2003 as compared with $32,975 or $19.09 per barrel in 2002.

	2003		2002	
	Liquids	Gas	Liquids	Gas
P&NG Revenue				
Canada	$463,824	$96,497	$517,029	$73,337
Trinidad	$46,318	–	$59,514	–
Ukraine	$2,411,759	–	–	–
	$2,921,901	$96,497	$576,543	$73,337
Production Volumes				
Canada (Bbls/Mcf per day)	30	40	37	49
Trinidad (Bbls per day)	4	–	5	–
Ukraine (Bbls per day)	253	–	–	–
	287	40	42	49
Prices per Barrel/Mcf				
Canada	$43.17	$6.62	$38.48	$4.12
Trinidad	$32.28	–	$34.36	–
Ukraine	$36.64	–	–	–
Average for 2003	$37.32	$6.62	$38.02	$4.12

Netbacks

In 2003, average operating netback to the Company was $21.66 per barrel compared to $11.48 in 2002. The Ukrainian production had an operating netback of $22.99 per barrel in 2003 while the Saskatchewan netback was $14.25 per barrel ($11.08 in 2002). Higher prices accounted for the increase in the netback in 2003. Trinidad operating netbacks were $13.55 in 2003 compared with $15.37 in 2002 mainly as a result of lower production during the year.

Administrative Expenses

General and administrative expenses increased to $493,339 in 2003 from $145,583 in 2002 and an analysis is contained in the following table.

	2003	2002
Administration & Management Fees	$134,241	$13,420
Accounting & Audit	$82,724	$37,799
Legal	$63,156	$10,845
Trustee & Listing Fees	$16,722	$9,355
Investor Relations & Shareholders Communications	$76,250	$18,262
Consultant Fees & Expenses	$19,188	$2,425
Office Rent	$42,803	$31,317
Travel	$16,307	$1,234
Other	$41,948	$20,926
	$493,339	$145,583

The Ukrainian operations added modestly to general and administrative costs in 2003. Kroes share of administration costs and management fees in Ukraine added $68,988 in 2003 and auditing costs increased by $43,552 due to the inclusion of Kashtan Petroleum Ltd's operations. A program started late in 2002 to enhance Kroes' investor profile accounted for the higher investor relations costs in 2003. Kroes continues to operate on a lean basis as management receives no salaries however in 2003 two officers received a nominal amount of $ 25,000 each for services contributed over the last few years. Consultants fees, office rent and travel were all higher due to the newly acquired Ukraine operations.

Depletion and Depreciation

In 2003, depletion and depreciation and site restoration costs increased to $172,717 from $28,914 in 2002. This increase is due to the addition of Ukrainian production in 2003. In 1998 the Company was required to write down the carrying value of its Saskatchewan oil and gas properties so these properties were carried on the books at no value.

Writedown of Capital Assets

The Company wrote down $169,316 related to the carrying costs of the Trinidad producing properties in 2003. Given the low productivity of the wells and low project priority, the decision was made to write down the producing portion of the cost pool but retain the $347,945 exploration component of the cost pool. Management believes there is still significant potential attributable to the exploratory play on the Icacos Block.

Exchange Loss

Zhoda 2001 Corporation, a wholly owned subsidiary of Kroes Energy Inc., deposited US $787,500 with the Credit Lyonnais Bank in Kyiv, Ukraine to provide 105% security for a US $750,000 line of credit the Bank extended to Kashtan Petroleum Ltd. During 2003 the US dollar fell from $1.5672 Cdn. in January to 1.2965 Cdn. at December 31 and as a result the Restricted Funds Held In Deposit was written down using the year-end rate. This resulted in a loss of $217,271 and when combined with other exchange losses resulted in a charge of $249,403 to net income.

Provision for Income Taxes

Income taxes incurred by the Kashtan joint venture in Ukraine were 30% of taxable income and $398,565 was Kroes' share during 2003. The small balance of $209 is due to Canadian operations and result in a total charge to net income of $ 398,774. Effective 2004, the rate of corporate income tax in Ukraine was reduced to 25%.

Gain on Sale of Assets

The Company sold its Saskatchewan properties for $475,000 with an effective date of December 1, 2003. As the sale represented all of the Company's Canadian oil and gas assets and the properties were written off in previous years under ceilings test requirements, a gain for the cash proceeds and the elimination of site restoration costs in Canada has been recorded on the income statements. Land administration and legal costs associated with the sale have been netted from the gain.

Liquidity and Capital Resource

The Company's operating and investing activities in 2003 were financed by cash flow, a dividend declared by the Ukraine joint venture and previous years' working capital. On September 9, 2002, the Company placed US$525,000 on deposit with Credit Lyonnais Bank, Ukraine at a Canadian dollar cost of $827,282 and on January 3, 2003 the remaining obligation of US$262,500 was forwarded bringing the total Canadian dollar cost of the deposit to $1,239,564.

The Company had 6,399,800 warrants outstanding and exercisable on February 28, 2004. 166,000 warrants were exercised in 2003 raising $49,800, while 4,094,200 warrants were exercised prior to the expiry date in 2004 and raised an additional $1,228,260.

On December 31, 2003 the Company had consolidated cash on hand of $607,639. When combined with the cash flow from operations, the sale of the Company's production in Saskatchewan, the proceeds of shares due to warrants, and the proposed dividend to be received from Kashtan, the Company will have more than sufficient funds to finance its administration and operations in 2004.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The preparation and presentation of the Company's consolidated financial statements and the overall quality of the Company's financial reporting are the responsibility of management. The financial statements have been prepared in accordance with generally accepted accounting principles and necessarily include estimates that are based on management's best judgments. Information contained elsewhere in the Annual Report is consistent, where applicable, with that contained in the financial statements.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of financial statements.

Grant Thornton LLP, an independent firm of chartered accountants appointed by the shareholders, have conducted an examination of the corporate and accounting records in order to express their opinion on the consolidated financial statements. The Audit Committee has met with representatives of Grant Thornton LLP and management in order to determine if management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The audit committee has reported its findings to the Board of Directors who have approved the consolidated financial statements.

Fred Callaway	David R. Malarchuk
President	*Controller*

Sign post leading to Lelyaki oil field

KROES ENERGY INC.
FIVE YEAR COMPARATIVE SUMMARY

Income Statement	2003	2002	2001	2000	1999
Total Net Revenue	$3,000,736	$632,669	$705,357	$842,558	$456,035
Other Items	$579,140	$1,915	-	-	-
Expenses	$1,381,346	$557,825	$553,719	$572,678	$441,464
Depletion and other provisions	$591,436	$28,914	$629,559	$42,036	$12,530
Total expenses	$1,972,782	$586,739	$1,183,278	$614,714	$453,994
Income tax	$398,774	$373,700	$0	$74,700	$0
Net income (loss)	$1,208,920	($325,855)	($477,921)	$153,144	$2,041
$ per weighted share outstanding	$0.044	($0.024)	($0.040)	$0.016	$0.000
$ per weighted share fully diluted	$0.043	($0.024)	($0.040)	$0.014	$0.000
Balance Sheet					
Working capital	$1,579,466	$874,860	$164,253	$319,116	$59,746
Restricted funds on deposit	1,028,586	827,282	0	0	0
Properties and equipment – net	1,963,004	1,937,632	559,713	1,171,809	1,188,210
Other assets	0	0	894,880	517,700	0
Total assets	$4,571,056	$3,639,774	$1,618,846	$2,008,625	$1,247,956
Provision for site restoration	70,328	117,749	55,249	43,873	32,483
Convertible debenture	0	0	24,530	142,764	138,159
Equity	4,500,728	3,522,025	1,539,067	1,821,988	1,077,314
Total liabilities and equity	$4,571,056	$3,639,774	$1,618,846	$2,008,625	$1,247,956
Common Shares – December 31,					
Outstanding	27,561,808	26,915,808	11,749,341	10,149,341	8,649,341
Fully diluted	36,611,588	35,070,588	13,056,007	12,479,341	9,479,000
Barrels of oil equivalent:					
Produced (Bbls)	107,108	17,155	18,122	19,710	16,777
Daily average (Bbls/day)	293	50	50	54	46

KROES ENERGY INC.
QUARTERLY INFORMATION

	Q1	Q2	Q3	Q4	TOTAL
2003					
Financial					
Oil and gas gross revenue	$627,260	$732,283	$901,498	$771,094	$3,032,135
Cash flow from operations	$273,139	$261,919	$420,081	$311,240	$1,266,379
$ per weighted share outstanding	$0.010	$0.010	0.015	$0.011	$0.046
$ per weighted share fully diluted	$0.010	0.009	0.015	0.011	0.046
Net income (loss)	$240,843	$245,722	$239,437	$482,918	$1,208,920
$ per weighted share outstanding	0.009	0.009	0.009	0.018	0.044
$ per weighted share fully diluted	0.009	0.009	0.008	0.017	0.043
Operating					
Liquids production (Bbl/d)	273	268	318	283	287
Liquids price $bbl - Ukraine	$32.84	$34.20	$35.36	$38.24	$36.64
Liquids price $bbl - Canada	$50.60	$39.72	$40.06	$42.24	$43.17
Liquids price $bbl - Trinidad	$41.28	$30.96	$28.43	$29.74	$32.28
Natural gas production (Mcf/d)	47	44	40	29	40
Natural gas prices $/mcf	$8.17	$6.60	$5.71	$5.49	$6.62
2002					
Financial					
Oil and gas gross revenue	$148,432	$153,906	$181,160	$182,286	$665,784
Cash flow from operations	$15,328	$(4,104)	$38,791	$29,917	$79,932
$ per weighted share outstanding	0.001	0	0.002	0.002	0.006
$ per weighted share fully diluted	0.001	0	0.002	0.002	0.006
Net income (loss)	$4,482	($10,514)	$31,523	($351,346)	($325,855)
$ per weighted share outstanding	0.000	(0.001)	0.002	(0.025)	(0.024)
$ per weighted share fully diluted	0.000	(0.001)	0.002	(0.025)	(0.024)
Operating					
Liquids production (Bbl/d)	47	38	42	42	42
Liquids price $bbl - Ukraine	$31.84	$38.42	$42.07	$42.06	$38.48
Liquids price $bbl - Trinidad	$25.79	$37.96	$44.52	$32.10	$34.36
Natural gas production (Mcf/d)	50	50	50	48	49
Natural gas prices $/mcf	$3.48	$3.91	$3.34	$5.74	$4.12

Auditors' Report

To the Shareholders of Kroes Energy Inc.

We have audited the consolidated balance sheets of Kroes Energy Inc. as at December 31, 2003 and 2002 and the consolidated statements of operations and retained earnings and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Grant Thornton LLP

Chartered Accountants

Calgary, Alberta

May 3, 2004

Kroes Energy Inc.
Consolidated Balance Sheet

December 31	2003	2002
Assets		
Current		
Cash and cash equivalents	$ 607,639	$ 824,077
Receivables	694,358	337,821
Prepaids and deposits	17,510	240,795
Inventory	438,715	82,000
	1,758,222	1,484,693
Property and equipment (Note 5)	1,963,004	1,937,632
Restricted funds (Note 6)	1,028,586	827,282
	$ 4,749,812	$ 4,249,607
Liabilities		
Current		
Bank indebtedness (Note 6)	$ –	$ 142,623
Payables and accruals	155,250	280,135
Income taxes payable	23,506	187,075
	178,756	609,833
Future site restoration and abandonment (Note 7)	70,328	117,749
	249,084	727,582
Shareholders' Equity		
Capital stock (Note 8)	4,585,659	4,440,609
Foreign currency translation adjustment	(375,267)	–
Retained earnings (deficit)	290,336	(918,584)
	4,500,728	3,522,025
	$ 4,749,812	$ 4,249,607

Commitments and contingency (Notes 6 and 15)

Subsequent event (Note 17)

See accompanying notes to the consolidated financial statements.

On behalf of the Board

F. Callaway
Director

E.M. Southern
Director

Kroes Energy Inc.
Consolidated Statements of Operations and Retained Earnings

Year Ended December 31	2003	2002
Revenue		
Oil and natural gas sales	$ 3,032,135	$ 665,784
Royalties	(31,399)	(33,115)
	3,000,736	632,669
Expenses		
Operating	888,007	408,549
General and administrative	493,339	145,583
Interest on debentures	–	2,078
Foreign exchange loss	249,403	1,615
Write down of property and equipment	169,316	–
Depletion and depreciation	172,717	28,914
	1,972,782	586,739
Earnings before other items and income taxes	1,027,954	45,930
Other items		
Interest and other income	45,763	1,915
Gain on disposal of property and equipment	533,977	–
Earnings before income taxes	1,607,694	47,845
Income taxes (Note 11)	398,774	373,700
Net earnings (loss)	$ 1,208,920	$ (325,855)
Deficit, beginning of year	$ (918,584)	$ (594,561)
Net earnings (loss)	1,208,920	(325,855)
Conversion of convertible debenture	–	1,832
Retained earnings (deficit), end of year	$ 290,336	$ (918,584)
Per share amounts:		
Basic (Note 9)	$ 0.044	$ (0.024)
Diluted (Note 9)	$ 0.043	$ (0.024)

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.
Consolidated Statement of Cash Flows

Year Ended December 31	2003	2002
Operating		
Net earnings (loss)	$ 1,208,920	$ (325,855)
Items not affecting cash		
Future income taxes	–	373,700
Depletion and depreciation	172,717	28,914
Write down of property and equipment	169,316	–
Gain on disposition of property and equipment	(533,977)	–
Foreign exchange loss	249,403	1,615
Debenture interest amortization	–	1,558
	1,266,379	79,932
Change in non-cash operating working capital (Note 14)	(778,421)	(177,599)
	487,958	(97,667)
Financing		
Proceeds from share issues, net	145,050	1,252,283
(Repayment) issuance of bank debt	(142,623)	142,623
	2,427	1,394,906
Investing		
Additions to property and equipment	(387,981)	(672)
Proceeds of disposition of property and equipment	475,000	3,346
Deferred acquisition costs	–	(166,097)
Restricted funds	(418,575)	(827,282)
Cash acquired on acquisition (Note 4)	–	335,239
	(331,556)	(655,466)
Change in non-cash investing working capital (Note 14)	–	43,768
Foreign currency translation adjustment	(375,267)	–
	(706,823)	(611,698)
Net change in cash and cash equivalents	(216,438)	685,541
Cash and cash equivalents,		
Beginning of year	824,077	138,536
End of year	$ 607,639	$ 824,077

See accompanying notes to the consolidated financial statements.

Notes to the Consolidated Financial Statements December 31, 2003

1. Nature of operations

The Company is engaged in the exploration for and production of petroleum and natural gas reserves in Canada, Trinidad and Ukraine.

Operations in Ukraine are conducted by JV Kashtan Petroleum Ltd. ("Kashtan"), a limited liability company, registered under the laws of Ukraine.

Kashtan is licensed to extract oil and gas from Lelyaky field in Pryluky District of Chernihiv Region, Ukraine. The operating license is for an initial term of twenty years, expiring in May 2016 and may be extended for a further twenty years with mutual consent of the Partners.

Ukraine continues to display emerging market characteristics and its legislation and business practices regarding banking operations, foreign currency transactions and taxation is constantly evolving as the government attempts to manage the economy. Risks inherent in conducting business in an emerging market economy include, but are not limited to, volatility in the financial markets and the general economy. Uncertainties over the development of the tax and legal environment, as well as difficulties associated with the consistent application of current laws and regulations have continued. Assets based in Ukraine represent approximately 77% of the consolidated assets. The Company's operations and financial position may be affected by these uncertainties.

2. Summary of significant accounting policies

Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles within the framework of the accounting policies summarized below.

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary from the respective dates of acquisition. All inter-company transactions and balances are eliminated upon consolidation.

Petroleum and natural gas properties

i) Capitalized costs

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, and costs of drilling both productive and non-productive wells. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion and depreciation.

ii) Depletion and depreciation

Depletion of exploration and development costs and depreciation of production equipment is provided using the unit-of-production method based upon estimated proved petroleum and natural gas reserves. The costs of significant undeveloped properties are excluded from costs subject to depletion. For depletion and depreciation purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Depreciation of office equipment is provided for on a declining balance method at 20% per annum which is designed to depreciate the cost of the assets over their estimated useful lives.

Notes to the Consolidated Financial Statements (continued)

iii) Ceiling test

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of petroleum and natural gas properties and production equipment, net of recorded future income taxes and the accumulated provision for site restoration and abandonment costs, is compared annually to an estimate of future net cash flow from the production of proved reserves. Net cash flow is estimated using year-end prices, less estimated future general and administrative expenses, financing costs and income taxes. Should this comparison indicate an excess carrying value, the excess is charged against earnings as additional depletion and depreciation.

iv) Future site restoration and abandonment costs

Estimated costs of future site restoration and abandonments, net of recoveries, are provided for over the life of proved reserves on a unit-of-production basis. An annual provision is recorded as additional depletion and depreciation. Costs are based on engineering estimates of the anticipated method and extent of site restoration in accordance with current legislation, industry practices and costs. The accumulated provision is reflected as a non-current liability and actual expenditures are charged against the accumulated provision when incurred.

Measurement uncertainty

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make certain assumptions and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from and affect the results reported in these consolidated financial statements as future confirming events occur (see Note 1).

Amounts recorded for depletion and depreciation, future site restoration and abandonment and amounts used in ceiling test calculations are based upon estimates of petroleum and natural gas reserves and future costs to develop those reserves. By their nature, these estimates of reserves, costs and related future cash flows are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

The amounts attributable to the fair value of stock options issued are based on estimates of the future volatility of the Company's share price, expected lives of the options, expected dividends and other relevant assumptions (see Note 10).

Joint ventures

Certain oil and gas exploration, development and production activities are conducted jointly with others. These consolidated financial statements reflect only the Company's proportionate interest in such activities.

Foreign currency translation

i) Self-sustaining foreign operations

All assets and liabilities are translated at the rate of exchange in effect at the balance sheet date. Revenues and expenses are translated at the average exchange rates for the period. Exchange gains and losses arising from the translation are deferred and included in a separate component of shareholders' equity.

ii) Accounts in foreign currencies

Accounts in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Exchange gains or losses are included in the consolidated statements of operations and retained earnings.

Notes to the Consolidated Financial Statements (continued)

Income taxes

Income taxes are recorded using the liability method of tax allocation. Future income taxes are calculated based on temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value using tax rates anticipated to apply in the periods when the temporary differences are expected to reverse.

Per share amounts

The treasury stock method is used to determine the dilutive effect of stock options, warrants and convertible debentures. The treasury stock method assumes that proceeds received from the exercise of in-the-money stock instruments are used to repurchase common shares at the average market rate for the period.

Stock-based compensation plan

The Company grants stock options to its directors, officers, consultants and employees upon employment and periodically during the period of employment.

Consideration received from employees or directors on the exercise of stock options is recorded as capital stock. Compensation costs have not been recognized for stock options granted to employees and directors. The Company has elected to follow the intrinsic value method of accounting for stock-based compensation arrangements. Since all options were granted with an exercise price equal to or higher than the estimated market price at the date of the grant, no compensation cost has been charged to earnings at the time of the option grant.

Financial instruments

Financial instruments of the Company consist mainly of cash and cash equivalents, receivables, bank indebtedness and payables and accruals. Unless otherwise disclosed, there are no significant differences between the carrying value of these financial instruments and their estimated fair value.

Cash and cash equivalents

Cash and cash equivalents are comprised of cash on hand, balances with banks and short-term deposits with a duration of three months or less. Bank borrowings are considered to be financing activities.

Inventory

Inventory is valued at the lower of cost and estimated net realizable value.

Revenue recognition

Oil and natural gas sales are recognized in earnings when reserves are produced and delivered to the purchaser.

3. Change in accounting policy

Effective January 1, 2002, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants ("CICA") with respect to accounting for stock-based compensation. The Company has adopted this accounting policy prospectively, without restating the consolidated financial statements of prior periods. In 2002, the adoption of this accounting policy did not have any effect on the financial position or results of operations of the Company. In 2002, the pro-forma disclosure related to the application of the fair value method was not provided as no options were issued on or after the date of adoption of the accounting policy.

Notes to the Consolidated Financial Statements (continued)

4. Corporate acquisition

Effective December 31, 2002, the Company met all conditions as set out by the Alberta Securities Commission and acquired all of the issued and outstanding shares of Zhoda 2001 Corporation ("Zhoda"), a private Canadian company holding a 45% interest in Kashtan. The acquisition has been accounted for by the purchase method of accounting and the consolidated financial statements include the assets and liabilities of Zhoda as at December 31, 2002. No results of operations have been included in the consolidated financial statements for the fiscal year end December 31, 2002. The fair value of the assets acquired is as follows:

Net assets acquired	
Cash	$ 335,239
Other assets	469,232
Property and equipment	1,400,880
	2,205,351
Current liabilities	(433,844)
Future site restoration	(52,230)
	$ 1,719,277
Consideration	
Shares issued	$ 1,032,000
Transaction costs	687,277
	$ 1,719,277

5. Property and equipment

			2003
	Cost	**Accumulated Depletion and Depreciation**	**Net Book Value**
Exploration and development costs	$ 1,166,555	$ 279,504	$ 887,051
Production equipment and processing facilities	1,080,607	38,525	1,042,082
Office equipment	45,613	11,742	33,871
	$ 2,292,775	$ 329,771	$ 1,963,004

			2002
	Cost	**Accumulated Depletion and Depreciation**	**Net Book Value**
Exploration and development costs	$ 1,535,265	$ 650,690	$ 884,575
Production equipment and processing facilities	1,134,109	104,180	1,029,929
Office equipment	29,837	6,709	23,128
	$ 2,699,211	$ 761,579	$ 1,937,632

Notes to the Consolidated Financial Statements (continued)

5. Property and equipment (Continued)

Included in exploration and development costs is the cost associated with the Trinidad assets of $347,945 (2002 – $532,079). Of this amount, properties with a value of $347,945 (2002 – $347,945) are considered unproved properties and not subject to depletion. In 2003, $169,316 was written off with respect to certain Trinidad producing properties.

6. Bank indebtedness

In 2002, the Company negotiated an operating line of credit to a maximum of $750,000 US bearing interest at LIBOR plus 1.75% for Kashtan. As security for the operating line, the Company was required to deposit $787,500 US with the bank in two installments. At December 31, 2003, there were no draws (2002 – $142,623) on the operating line. As at December 31, 2003, $1,028,586 (2002 – $827,282) is deposited with the bank.

The restricted funds will remain on deposit until the Kashtan joint venture is self financing at which time the funds will be returned to Kroes.

7. Future site restoration and abandonment

At December 31, 2003, the estimated total future site restoration costs to be accrued over the life of remaining proved reserves were estimated at $600,000 (2002 - $402,000) of which $70,328 (2002 - $117,749) has been accrued. This estimate is subject to change based on amendments to environmental laws and as new information concerning operations becomes available. In 2003 the Canadian oil and gas properties were sold and the Company was relieved from $81,593 of site restoration liabilities associated with these properties.

8. Capital stock

a) Authorized:

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

b) Issued and outstanding:

	2003		2002	
	Number of Shares	Amount	Number of Shares	Amount
Common shares				
Balance, beginning of year	26,915,808	$ 4,440,609	11,749,341	$ 2,131,326
Issued for cash	–	–	6,399,800	1,252,283
Issued on conversion of debentures	–	–	166,667	25,000
Issued for cash on exercise of options	480,000	95,250	–	–
Issued for cash on exercise of warrants	166,000	49,800	–	–
Issued for acquisition of Zhoda 2001 Corp	–	–	8,600,000	1,032,000
Balance, end of year	27,561,808	$ 4,585,659	26,915,808	$ 4,440,609

Notes to the Consolidated Financial Statements (continued)

The shares issued for the purchase of Zhoda are pursuant to an escrow agreement. On closing of the acquisition of Zhoda, the TSX Venture Exchange ("Exchange") required the 8,600,000 common shares issued as consideration to be placed in escrow using its Value Security Escrow Agreement. This agreement provides for the release of 10% of the escrowed shares on January 17, 2003 and 15% on each following six month period. At December 31, 2003, 2,150,000 shares had been released and 6,450,000 remain in escrow. Prior to each release, the Exchange requires confirmation that the Ukrainian joint venture interest is in good standing and that there is no indication it will be impaired or written off.

c) Purchase warrants

For each common share issued for cash, the holder of the common share is entitled to one purchase warrant, 6,399,800 in total. The holder can exercise the purchase warrant at any time until February 29, 2004 at a purchase price of $0.30 per warrant. During 2003, 166,000 share purchase warrants were exercised for proceeds of $49,800. Subsequent to year end, 4,094,200 warrants were exercised for total cash proceeds of $1,228,260. All remaining warrants expired.

As part of the public offering, the agent received 604,980 warrants to purchase common shares. Each warrant entitles the agent to acquire one common share for a purchase price of $0.25 per warrant until August 29, 2004.

9. Per share information

Basic earnings per common share is computed by dividing net earnings by the weighted average number of common shares outstanding for the year. Diluted earnings per common share is computed by dividing net earnings by the diluted weighted average number of common shares outstanding for the year. In the calculation of diluted per share amounts, options under the stock option plan and purchase warrants are assumed to have been converted or exercised on the later of the beginning of the year and the date granted. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares.

	2003	2002
Weighted average shares outstanding:		
Basic	27,352,712	13,722,841
Shares issued pursuant to options and warrants	471,481	353,913
Diluted	27,824,193	14,076,754
Net earnings per common share:		
Basic	$ 0.044	$ (0.024)
Diluted	0.043	(0.024)

In the 2003 calculation of diluted weighted average shares outstanding 6,399,800 (2002 – 7,004,780) warrants were excluded from the calculations, as they were anti-dilutive.

Notes to the Consolidated Financial Statements (continued)

10. Stock-based compensation plan

The Company grants stock options to its directors, officers and consultants. The Board has a policy of reserving up to 10% of the outstanding common shares for issuance to eligible participants. At December 31, 2003, there were 2,756,181 (2002 – 2,691,581) common shares reserved for this purpose. All options vest immediately upon granting.

At December 31, 2003, 2,045,000 options (2002 – 1,150,000), with exercise prices between $0.13 and $0.25, were outstanding and exercisable at various dates to November 21, 2008. The exercise price of each option granted was equal to or higher than the estimated market price of the Company's common shares on the date of the grant.

The following tables summarize the information about the stock options as at December 31:

	2003			2002		
	Shares		Weighted Average Exercise Price	Shares		Weighted Average Exercise Price
Outstanding, beginning of year	1,150,000	$	0.16	1,150,000	$	0.16
Granted	1,375,000		0.25	–		–
Exercised	(480,000)		0.20	–		–
Outstanding, end of year	2,045,000	$	0.21	1,150,000	$	0.16
Options exercisable, end of year	2,045,000	$	0.21	1,150,000	$	0.16

Outstanding Options					Exercisable Options		
Range of Exercise Prices	Number Outstanding at December 31, 2003		Weighted Average Exercise Price	Weighted Average Years to Expiry	Number Exercisable at December 31, 2003		Weighted Average Exercise Price
$0.13	670,000	$	0.13	2.9	670,000	$	0.13
$0.25	1,375,000	$	0.25	4.8	1,375,000	$	0.25
	2,045,000	$	0.21		2,045,000	$	0.21

CICA Handbook section 3870 "Stock-Based Compensation" establishes financial accounting and reporting standards for stock-based employee compensation plans as well as transactions in which an entity issues its equity instruments to acquire goods or services from non-employees. The Company has elected to follow the intrinsic value method of accounting for stock-based compensation arrangements. Since all options were granted with an exercise price equal to or higher than the estimated market price at the date of the grant, no compensation cost has been charged to earnings at the time of the option grant. Had compensation cost for the Company's stock options been determined based on the fair value method at the grant dates of the awards consistent with the methodology prescribed by Handbook section 3870, the Company's net earnings and net earnings per share for the year ended December 31, 2003 would have been reduced to the pro-forma amounts below.

Notes to the Consolidated Financial Statements (continued)

		2003
Net earnings		
As reported	$	1,208,920
Less fair value of options		(217,307)
Pro-forma	$	991,613
Net earnings per common share – basic		
As reported	$	0.044
Pro-forma	$	0.036
Net earnings per common share – diluted		
As reported	$	0.043
Pro-forma	$	0.036

The weighted average fair market value of options granted during the year ended December 31, 2003 is $0.16 per option. The fair value of each option granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	2003
Risk-free interest rate	4.51%
Estimated hold period prior to exercise (years)	5
Volatility in the price of the Company's common shares	96%
Dividend yield	0%

11. Income taxes

a) Provision for income taxes		2003		2002
Earnings before income taxes	$	1,607,694	$	47,845
Expected tax expense at combined federal and provincial rate of 39.5% (2002 – 42.1%)	$	635,039	$	20,152
Increase (decrease) resulting from:				
Resource allowance		12,490		(8,100)
Statutory tax rate differences		(110,199)		–
Other		(54,904)		8,145
Valuation allowance and tax rate reductions		(83,652)		353,503
Provision for future income taxes		–		373,700
Provision for current income taxes		398,774		–
	$	398,774	$	373,700

Notes to the Consolidated Financial Statements (continued)

b) Future income taxes		2003		2002
Future income taxes consist of the following temporary differences:				
Property and equipment	$	389,881	$	343,349
Non-capital losses		196,514		137,414
Share issue costs		147,984		193,474
Future site restoration		27,780		49,596
Impact of foreign tax rate differences		(181,262)		(179,787)
		580,897		544,046
Valuation allowance		(580,897)		(544,046)
Future income taxes	$	–	$	–

c) Tax losses available

The Company has incurred losses for Canadian income tax purposes of approximately $497,600 (2002 – $326,000), the related benefit of these losses has not been recognized in the financial statements. Unless sufficient taxable income is earned these losses will expire as follows:

2004	$	13,800
2005		41,900
2006		21,400
2007		46,700
2008		144,900
2009		18,200
2010		210,700

12. Geographic segments

The Company is organized into divisions by geographic area consisting of Canada, Trinidad and Ukraine. All divisions derive revenue from oil and gas properties or are pursuing oil and gas production from properties:

2003		Canada		Trinidad		Ukraine		Total
Revenue, net	$	542,659	$	46,318	$	2,411,759	$	3,000,736
Net earnings (loss)		367,886		(198,858)		1,039,892		1,208,920
Identifiable assets		636,806		462,381		3,650,625		4,749,812

2002		Canada		Trinidad		Ukraine		Total
Revenue, net	$	574,770	$	57,899	$	–	$	632,669
Net (loss) earnings		(328,296)		2,441		–		(325,855)
Identifiable assets		563,032		653,943		3,032,632*		4,249,607

** Includes the restricted funds related to Ukraine (see Note 6).*

13. Financial instruments

Credit risk

The Company, in the normal course of business, monitors the financial condition of its customers and reviews credit history of each new customer. The Company establishes an allowance for doubtful accounts that corresponds to the specific credit risk of its customers, historical trends and economic circumstances. The allowance as at December 31, 2003 is $56,592 (2002 - $115,999).

Foreign currency risk

The Company has cash and cash equivalents, receivables, bank indebtedness and payables and accruals denominated in foreign currencies, and thus are exposed to the financial risk of earnings fluctuations arising from changes in foreign exchange rates and the degree of volatility of these rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

Sales within Ukraine by Kashtan are by law denominated in local currency (Hryvna). Funds for repatriation back to Canada are then converted to, and transmitted in, US Dollars. Regulations imposed by the Ukrainian authorities are subject to ongoing change, and accordingly the flow of funds to Canada is subject to possible interruption.

14. Supplemental cash flow information

	2003	2002
Change in non-cash working capital:		
Receivables	$ (356,537)	$ (19,948)
Prepaid	223,285	(12,931)
Inventory	(356,715)	697
Payables and accruals	(288,454)	(101,649)
	$ (778,421)	$ (133,831)
Working capital consists of:		
Operating working capital	$ (778,421)	$ (177,599)
Investing working capital	–	43,768
	$ (778,421)	$ (133,831)
Other items		
Interest paid	$ –	$ 1,054
Shares issued for business acquisition	–	8,600,000
Debentures paid by issue of shares	$ –	$ 25,000
Shares issued to pay debentures	–	166,667
Cash and cash equivalents consist of:		
Cash on hand and balances with banks	$ 607,639	$ 473,113
Short-term deposits	–	350,964
	$ 607,639	$ 824,077

Notes to the Consolidated Financial Statements (continued)

15. Commitments and contingency

a) The Company has committed to monthly rental payments for office rental until May 2005 as follows:

2004	$ 26,403
2005	11,001

b) The Company has been made aware of a potential legal claim associated with normal operations. This potential claim is minor in nature and is not expected to have a material impact on the financial position or results of operations of the Company.

16. Comparative figures

Certain comparative figures have been reclassified to conform to the current year's presentation.

17. Subsequent event

On January 8, 2004, the Company issued 200,000 options to officers of the Company. The options are exercisable at $0.33 per share and will expire if not exercised by January 7, 2009.

NOTES

NOTES

Offices

260, 435 – 4th Avenue S.W.
Calgary, Alberta, Canada
T2P 3A8

#141, 24 Geroiv Stalingradu Avenue
Kyiv, Ukraine 04210k

400 Chin Aleong Street
Block 3, Palmiste
San Fernando, Trinidad, West Indies

Banker

Bank of Nova Scotia
Calgary, Alberta

Bank of Nova Scotia
San Fernando
Trinidad, West Indies

Credit Lyonnais Ukraine
Kyiv, Ukraine

Auditor

Grant Thornton LLP
Calgary, Alberta

Solicitors

Dunphy Best Blocksam LLP
Calgary, Alberta

Transfer Agent

Computershare Trust Company of Canada
Calgary, Alberta

Stock Exchange Listing
TSX Venture Exchange Symbol: KRS

Investor Relations

CHF Investor Relations Inc.
Olav Svela, Vice President
Tel: 416-868-1079
Fax: 416-868-6198
olav@chfir.com

Directors and Officers

Fred Callaway, C.A., President and Director: Former Vice President of Home Oil Company Limited.

Edward M. Southern, Executive Vice President and Director: Honorary Consul of Ukraine for Alberta, Chairman of Energy Sector of the Canada-Ukraine Intergovernmental Economic Commission.

Stephan Benediktson, P. Eng., Director: Founder and former Chairman/CEO of Benson Petroleum Ltd.

Stewart D. Gossen: Vice President.

David Malarchuk: Controller.

David Powell, B. Sc., D.I.C., FGS, Director: Chairman, Talisman Energy Inc. and former President/CEO of Home Oil Company Limited.

Dr. James E. Werbicki, M. D., Director: Chief of Emergency Medicine, Saskatoon City Hospital, Saskatoon, Saskatchewan.

Darrell M. Zakreski, Director: President, Bullseye Realty Ltd., inner city real estate development .

Richard A. Wilson, Q.C., Secretary.

KROES ENERGY INC.